

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

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Investigation by the Department of)

Telecommunications and Energy on Its Own)

Motion into the Pricing and Procurement) D.T.E. 99-60

of Default Service Pursuant to)

G.L. c. 164, § 1B(d).)

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COMMENTS OF PG&E NATIONAL ENERGY GROUP
ON PROPOSED GUIDELINES FOR DEFAULT SERVICE

I. INTRODUCTION

PG&E National Energy Group⁽¹⁾ ("PG&E NEG" or the "Company") appreciates the opportunity to submit comments on the proposed guidelines for default service pricing and procurement outlined in the May 12, 2000 order of the Department of Telecommunications and Energy ("DTE" or "Department"), D.T.E 99-60-A ("Proposed Guidelines"). During the technical conference held on May 25, 2000, the Company provided oral comments on the questions posed at the conclusion of the Department's Proposed Guidelines order. These written comments respond in greater detail to Question 2 (frequency of solicitations for large C/I customers) and Question 7 (Department oversight of the procurement process).

As a general observation regarding the Proposed Guidelines, the Company commends the Department for developing a meaningful and principled set of guidelines that will result in market-based default service rates. In particular, we agree with the Department's first guiding principle for the design of default service:

default service prices should be market based, be procured through reasonable business practices, and take into account the costs of providing default service, consistent with the development of robust competitive retail markets.

Proposed Guidelines at 4-5. As we indicated in our Initial Comments, "the destructive potential of a regulated, below-market default service in Massachusetts is unlimited." *Initial Comments of PG&E Corporation* at 1. The Proposed Guidelines reflect a serious effort by the Department to avoid creating such a hazard to the development of competitive market in the Commonwealth. The few refinements suggested below in response to Questions 2 and 7 will, in our view, enhance the chances of that success.

II. RESPONSE TO QUESTION 2

Are there data justifying more frequent solicitations for large commercial and industrial customers?

Yes, however, because the proposed default service solicitation process is not yet in place in Massachusetts, we cannot present the Department with historical data on default service which illustrates our concerns. Instead, we have assembled other data which we believe demonstrates why quarterly solicitations for large C&I customers will better meet

the Department's second guiding principle for the procurement and pricing of default service: "costs associated with providing default service should be minimized." Proposed Guidelines at 5.

Chart 1 shows the historical peak demand of default service customers of National Grid from January, 1999 through December, 1999 in a solid bold line on the left of the chart.⁽²⁾ On the right hand side of that chart is a reasonable, hypothetical base case forecast of the default service load of National Grid for the year 2000 (solid line), along with a low case (dotted line) and a high case (line with diamonds). From a wholesale supplier's perspective, the cost of serving National Grid's "all requirements" default service load will be a function of two forms of risk: volumetric uncertainty and the uncertainty of the cost to serve and hedge. Volumetric uncertainty is a function of (1) the type of customer (customer class); (2) customers' historical monthly consumption; (3) customers' historical monthly peak demand; (4) regulatory rules for entering and exiting default service; (5) weather; (6) amount of time prior to the initiation of service (less risk the nearer to the time of service); and (7) the term of the transaction (less volume risk with shorter service term). The other risk--the cost to serve and hedge--is a function of (1) procedural delays such as regulatory delay in approving contracts once a bid is submitted, delay in credit approval, and extended negotiations over terms and conditions; and (2) threats to the liquidity of Over-The-Counter ("OTC") products including ISO price interventions, and changes in market structure (*i.e.* NHLO, ICAP, CMS), and (3) the actual default service pricing the customer sees.

These volumetric risks are magnified for the large C&I customer load which can enter or exit default service with virtually no notice. The longer the period of time covered by a single solicitation, the greater the volume uncertainty and the greater the uncertainty regarding the cost to serve or hedge. Assuming *arguendo* that the forecasted levels shown on Chart 1 are reasonable, for the short three month period between January, 2000 and April, 2000, the reasonable range of peak load for which a supplier would have to plan is between a high of 499 MW in the high case and a low of 382 MW in the low case. That represents a 30 percent variation in forecasted peak loads over only three months. However, if you extend the bid period out to six months, the high case for peak load increases to 560 MW in June compared to the low of 382 MW in April -- a potential variation of 47 percent.

Faced with that degree of peak load variation, the wholesale supplier will purchase an "on peak" product for only a portion of the forecasted peak, buying options for the remainder, and paying a premium for such options. The wider the spread in the forecasted peaks which need to be covered, the more options that must be purchased. Therefore, in assembling a bid to provide default service, the bidder must factor into his bid price the price of the options he must purchase to cover the volumetric risk inherent in load for the entire period of the RFP. By shortening the bid periods, the total risk premium paid for options for the period can be minimized to customers.

The same principle holds true whether one is looking at forecasts of MWs or MWhs. Chart 2 shows historic data for monthly consumption for National Grid default service

customers, and a base case, plus a low and high forecast of monthly consumption for National Grid default service customers for the year 2000. The longer the solicitation period, the larger the variation in monthly consumption for which the wholesale supplier must plan and charge a premium.

In our final chart, Chart 3, the Company has assembled historical data on projected "on peak" product prices over time. For example, looking at the left-most column, on May 3, 1999, the projected price of a product to supply a MWh on peak in May of 2000 was \$24.50; for June, 2000 it was \$27.50; for July, 2000, \$38.00; and for August, 2000, \$41.00. Approximately one year later, on April 28, 2000, the projected prices were \$35.88, \$58.50, \$90.00 and \$90.00 respectively. Had the Department conducted an annual solicitation for large C&I customers for a one year period in May, 1999, bid prices for May, 2000 of \$24.50 would have been well below the current peak product price available in April of 2000 of \$35.88. The price disparity is even greater for June, July and August of 2000. We believe this chart illustrates that if bidders have to serve very long periods (such as 6 months) and must contract for "on peak" products that far in advance, the price bid for default service is more likely to be materially higher or lower than the product prices available in the market nearer to the time of consumption of the default service power. That degree of disparity will cause customer confusion and unhealthy, potentially violent shifts in load moving on and off default service. Therefore, shorter solicitation periods are highly advisable for customer classes with the ability to migrate between competitive suppliers and default service. We believe that such customers are currently limited to the large C&I customers.

III. RESPONSE TO QUESTION 7

Please discuss in specific detail what function, if any, the Department should have in overseeing default service procurement.

Whatever oversight the Department chooses to exercise, it is critical that it be done as much as practicable prior to the issuance of Requests for Proposals by distribution companies, not after. The applicable rules or guidelines should be articulated by the Department prospectively to minimize the time between bid submission and contract execution. As the quantitative analysis above demonstrates, for every month that a bidder must manage risk prior to performing, there is a cost penalty to the default service consumer. Moreover, if the market is very volatile and bidders have no guarantee of performing on time if selected due to bid disputes or administrative review processes, fewer may participate.

The Company also recommends that the following specific procedures be considered by the Department:

A. Guidelines for Foreseeable Bid Outcomes

Based on recent experience with standard offer solicitations in Massachusetts and other Northeast states such as Maine and New York, it is foreseeable that one or more of the following outcomes may occur:

- (1) multiple, competition bids are received;
- (2) no bids are received;
- (3) only one bid is received;
- (4) all bids received have prices which are materially higher than expected by distribution companies and/or regulators.

We believe it would be beneficial for bidders, customers, and the distribution companies if the Department clarifies now what options distribution companies would have, or not have, in the event that any of the four outcomes above occurred. For example, if no bids were received, would the distribution company be required to rebid at least once before petitioning the Department for another alternative? Would the distribution company automatically become the default supplier itself? Is one bid sufficient or would the distribution company automatically conduct a rebid? If all bids come in higher than expected or desired by the distribution company, would the distribution company have the right to refuse all bids?

Obviously, the Department has the option to wait and see if any of these outcomes occur, and develop rules and procedures at that time. However, there are two problems with that course. First, there may not be enough time. RFPs take time to administer. Moreover, under scenarios 3 and 4, the Department would have to deal appropriately with the rights of good faith bidders absent established rules allowing for all bids to be rejected or for sole bids to be rejected. The second problem is that wholesale suppliers need to know if they are bidding against other potential default service suppliers or against the distribution company as the supplier of last resort. Therefore, we urge the Department to prospectively determine what options distribution companies would have under a range of outcomes in the solicitation process.

B. Prohibit Award Disputes But Not Feedback to the Department by Bidders

We support distribution companies prohibiting bidders from petitioning the Department to challenge the outcome of completed default service solicitations. However, the Department should not allow distribution companies or their representatives to require as a condition of bidding that bidders waive their right to discuss with the Department, subsequent to the bid award, problems that they may have encountered in the bid process. This issue has arisen in both asset sales and standard offer solicitations. Imposing perpetual gag rules on bidders could create a dynamic in Massachusetts where regulators believe all is well with the default service bid processes when, in fact, important alterations need to be made *prospectively for subsequent bids*. Therefore, we do not oppose a prohibition on bid disputes. However, we do oppose the current practice among some Massachusetts distribution companies of asking bidders to waive their right to speak with the Department regarding problems encountered in solicitation processes.

C. Default Service Solicitations Should Be Staggered

The Department should develop and publish a long-term schedule for default service solicitations in consultation with or after comment by the distribution companies and interested suppliers. Such a schedule

is crucial in order for each distribution company to receive a competitive response from the market and for the market to anticipate and fine tune proposals to each distribution company.

If the Department would like any of the points raised in these comments explained or quantified further, we would be pleased to do so.

Respectfully submitted,

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1. PG&E National Energy Group is the name of the newly restructured and integrated competitive subsidiaries of PG&E Corporation. PG&E Corporation, the parent company of PG&E National Energy Group, filed Initial and Reply Comments in this docket on July 14 and 28, 1999, respectively, in response to the Department's Notice of Inquiry/Generic Proceeding dated June 21, 1999, D.T.E. 99-60.

2. The historical data is from a request for proposals from National Grid for default service for the May-October, 2000 period, dated February 15, 2000.